

To: All Pension Managers (internal and outsourced)
All Pension Client Managers

My ref: TE/EE/100

Your ref:

Date: 8 February 2006

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Dear colleagues

LGPS: Compliance with HMRC Tax Regime from April 2006

You may be aware that the ODPM is consulting on a number of policy issues relating to the implementation of the new HMRC tax regime from 6 April 2006 - see link to their letters of 1st and 3rd February 2006 at <http://www.xoq83.dial.pipex.com/>

The following information has been drawn up to complement the ODPM letters (parts of which are reproduced below) and to bring to your attention technical and administrative matters that the LGPC Secretariat believes administering authorities should currently be considering. You may wish to make employers in your Fund aware of a number of these issues.

1. Unauthorised Payments

As pointed out in the ODPM letter of 3 February 2006, it appears that Compensatory Added Years (CAY) may be treated as unauthorised payments under the new tax regime if paid through the pension fund. The question of whether or not CAY paid through the pension fund is an authorised or unauthorised payment is being followed up with HMRC. However, if HMRC confirm that it would be an unauthorised payment, it will be necessary, before 6 April 2006, to follow one or a combination of the following approaches:

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Option A: Administering authorities continue to pay CAY on behalf of employers but payments would be charged direct to the relevant employer's bank account i.e. the administering authority would simply act as a payroll processor.

Option B: Administering authorities would have to pay any CAYs they were asked to pay through a separate revenue account. The CAY payments would then subsequently be recharged to the relevant employer or, alternatively, the employer could place money into the relevant revenue account the day before the CAY is paid.

Option C: Employers would have to pay their own CAYs. The administering authority / pension fund would no longer have any involvement.

Option D: All CAYs could be treated as if awarded under the LGPS augmentation provisions, allowing them to be paid through the pension fund directly (with current recharging built in to ongoing employer contribution rates).

Option E: Allow the flexibility to follow any or a combination of options A, B, C or D.

The LGPC Secretariat believes that option E is preferable as it permits local discretion on how to deal with the issue. To permit option D or E, the former regulation 143 would need to be reinstated (and allow for up to 10 CAY to be converted to augmented membership). The ODPM has asked authorities to express a view on which option they favour or whether they would favour some other alternative arrangement.

If **Option B** is an administering authority's preferred option, they should check that they have powers to pay sums from a revenue account on behalf of other bodies, particularly where payments are being paid on behalf of non-local authority employers.

If **Option C** is preferred, administering authorities will wish to ensure that the employing authority has the appropriate level of knowledge in order to implement the annual Pensions Increase award and to calculate abatement during, and claw back following, a period of re-employment with a scheme employer. This, of course, would apply both in the case of existing CAY awards as at 5 April 2006 and in the case of new awards made by the employer after that date.

If **Option D** is preferred, there are a number of matters to be considered. Firstly, in order to ensure that the value of the augmented membership (following conversion from CAY) does not count towards the Annual Allowance under the new tax regime, it will be necessary to ensure the conversion occurs prior to 6 April 2006. This will also mean that the pensioners affected by the conversion who are in pensionable employment elsewhere (whether in the public or private sector) and who wish to opt in that other employment for Primary or Enhanced Lifetime Allowance protection will have the value of the converted CAY protected within the Primary or Enhanced

protection (which would not be the case if conversion happened on or after 6 April 2006). One issue to consider under this option is that conversion to augmented membership, unless paid for by a capital payment into the Fund, increases liabilities on the Fund, even though we know this liability can be matched by sums equivalent to the recharge amount which will come into the Fund over a period of time via the employer's contribution rate. For those employer's who do not have any existing active members, and hence cannot pay for the augmented membership via the ongoing employer's contribution rate, it would be necessary to ensure that the money was recouped via instalments (which, in the absence of any specific amending provision to allow for this, could – it would appear - be achieved via existing regulation 77(6)). Finally, Option D would only deal with existing CAY cases as at 5 April 2006. Any CAY awarded after that date would have to be dealt with under either Options A, B or C or, alternatively, employing authorities would have to amend their discretionary policies and award augmented membership under regulation 52 rather than CAY (although it should be noted that the maximum award under regulation 52 is limited to 6 and 2/3rd years whereas up to 10 CAY can be awarded). It is important to note, however, that any change to an employing authority's CAY policy must be published within one month of the date of the decision to change it and cannot come into effect until one month has passed since the date of publication of the amended policy. The time within which to effect a change to the CAY policy prior to 6 April 2006 is, therefore, very limited. A change to a scheme employer's augmentation policy must be notified to the administering authority within one month of the date of the decision to change the policy.

If HMRC were, on the other hand, to determine that CAY was an authorised payment, none of the above would apply but such a decision from HMRC would bring its own issues. For example:

- CAY as at 5 April 2006 would count towards a person's Lifetime Allowance should there be any future Benefit Crystallisation Event (and would count in the calculation of any Primary or Enhanced Lifetime Allowance protection)
- should CAY lump sums paid in the past have been excluded from the £30,000 termination payment test (because, if they are an authorised payment, wouldn't this make them a pension lump sum and therefore tax free)?

2. Other payments that may be "unauthorised" under the new tax regime

Assuming that HMRC deem that other unfunded payments which an administering authority may currently be paying on behalf of employers (such as Crombie, gratuities, injury allowances) will also be treated as unauthorised payments from 6 April 2006 if paid from the Fund and then recharged, administering authorities will no longer be able to pay the amounts from the Fund and instead will either have to charge payments direct to the relevant employer's bank account, or pay through a separate revenue account or pass responsibility for processing the payments back to the relevant employer.

The same issues outlined for Options B and C in Section 1 above would again need to be considered.

Further changes to the LGPS may be required to remove provisions relating to current payments permitted by the LGPS that would be treated as unauthorised from 6 April 2006. These are generally of a minor nature but, to date, we have identified the following:

- the remote possibility of receipt of employee contributions beyond age 75 which neither HMRC nor LGPS will permit, ;
- the payment of retirement or death related lump sums beyond age 75;
- the refund of contributions deducted in error (though we are waiting clarification on this);
- the refund of contributions through payroll when a member opts out within 3 months (these will all need to be carried out via the pension fund in future).

3. Taxation of members' benefits above the lifetime allowance (LTA)

Where scheme members have benefits whose capital value (when aggregated with other crystallised pension benefits) exceeds the standard LTA (£1.5million in 2006/07) or a member's Primary or Enhanced LTA, a recovery tax charge will apply. This charge will be calculated with regard to how the excess is taken by the scheme member – as a lump sum or as a pension. The scheme could limit the options available to scheme members in this case or allow some degree of choice. The ODPM are suggesting the Scheme could adopt one of the following approaches:

Option A: The scheme only allows members' capital value in excess of the LTA to be taken as cash after deduction of the 55% tax recovery charge required by the Finance Act 2004 – i.e. as a lump sum calculated using a 12:1 conversion factor for any excess benefits that relate to pension. This lump sum is payable over and above the maximum LTA permissible value (25% of the LTA in 2006/7 = £375,000).

Option B: The scheme could require members to take the excess over LTA according to the existing scheme rules which provide for a pension accruing at a rate of 1/80th p.a. and a 3/80^{ths} tax-free lump sum on retirement. Tax would be recovered from the excess lump sum at 55% and the tax payable by the Fund on the excess pension would be at the rate of 25% as required by the Finance Act 2004. The reduction in the pension necessary to recover the tax could be carried out over a fixed period or over the average length of pension in payment, as determined by the Government Actuaries Department (GAD).

Option C: The scheme requires members to take all the excess over LTA as a pension, based on a reverse commutation factor of 1:12, with a tax recovery charge of 25% (calculated as mentioned in B)

Option D: Allow scheme members the flexibility to choose option A, B, C or anything in between, with taxation applying to benefits above the LTA in accordance with the Finance Act 2004.

The simplest solution would be to proceed according to Option A.

One matter that GAD will need to consider in relation to Option B is that if the reduction in pension to recover the tax is for a fixed period only, the pension in payment would then rise at the end of the recovery period. It will be necessary to determine how HMRC would view this e.g. would there be any possibility that the increases could cause a problem in relation to the Annual Allowance check?

Option C, using a reverse commutation factor of 1:12, would potentially result in an additional strain on the Fund since the “real” cost of purchasing each £1 of pension, according to the tables produced by the Government Actuary in relation to regulation 58 of the LGPS Regulations (dated 27 December 2001) is as shown in the table below:

Type of member	Cost of £1 of pension at age 60	Cost of £1 of pension at age 65
Single male	£15.82	£13.30
Single female	£17.12	£14.71

Option D would provide more flexibility for scheme members but has the potential drawback outlined in Option C for those members who opt to take all the excess as pension.

The ODPM are asking authorities for a view on which option they would support.

4. Protections

Under the new HMRC regime, scheme members who have already accrued benefits in excess of the LTA or who believe they may do so in the future may choose, in the former case, to elect for primary and/or enhanced protection and, in the latter case, for enhanced protection by 5 April 2009. HMRC intend these protections to go some way towards protecting benefits accrued to 5 April 2006 that might be affected by the new tax regime. An election must be made by the Scheme member by 5 April 2009 in both cases.

Enhanced protection permits growth in benefits beyond 5 April 2006 up to certain limits (generally speaking, the greater of 5%, RPI or increases in pensionable pay). If these limits are exceeded, enhanced protection is lost. Scheme members would then be subject to the same provisions for taxation as adopted by the scheme for excess over the standard LTA or the Primary LTA protection for those who have opted for that (as per the outcome of Section 3 above).

It is necessary for the ODPM to consider how the LGPS should be amended to treat members who elect for enhanced protection. The ODPM could follow one of the following approaches:

Option A: Scheme members who have applied for enhanced protection would be allowed to continue to accrue membership in the scheme. This will inevitably mean that their benefits are more likely to exceed the enhanced benefit limits more quickly than if they were not allowed to continue accruing membership of the LGPS after 5 April 2006. It is acknowledged that scheme members could of course end their enhanced protection should they wish to by taking certain steps that would produce this result (for example, by contributing to an AVC or allowing the value of their benefits to exceed the limits mentioned above).

Where a member's standard $1/80^{\text{th}}$ pension and $3/80^{\text{ths}}$ lump sum benefits, at retirement, exceeds the enhanced benefit limits, the ODPM could allow the member the option, before they retire, to elect for their LGPS benefits to be limited (reduced) to the value that would keep them within the enhanced protection limits mentioned above (so that they continue to benefit from enhanced protection and thereby avoid tax on any excess above the standard LTA or primary protection allowance if they have opted for it). If they do not elect, and their benefits exceed the enhanced protection limits mentioned above, they will automatically become subject to, and pay tax on the excess over, the standard LTA (or primary protection if they have applied for that), which may be more financially attractive for some scheme members.

In this option, if a member did not want to continue in the LGPS, they would have the option to opt out of the scheme but, in that scenario, their LGPS benefits accrued up to the date of opting out would just increase in line with inflation and they would lose LGPS ill-health, redundancy / efficiency and death cover (i.e. no special provisions would be incorporated for them).

The following example might help to explain option A.

The value of a member's benefits at 5 April 2006 is £2.5 million (based on 35 years membership and final pay of £248,447) and the member registers for both Primary and Enhanced protection. His Primary protection is therefore 1.67 times the standard LTA of £1.5 million.

5 years later the member retires (i.e. on 5 April 2011) and the standard LTA is then £1.8 million.

His actual benefits based on total membership of 40 years and the final years pay of £278,261 are worth £3.2 million.

Under the Primary protection the member can have benefits of £3 million (i.e. £1.8 million x 1.67).

Under the Enhanced protection the member can have benefits (assuming RPI from April 2006 to five years later and the increase permitted by the The Registered Pension Schemes (Defined Benefit Arrangements - Uprated Opening Value) Regulations have both been less than the compounded value of 5% each year over that same period) of the greater of:

- £2.5 million with 5 years accumulative 5% increases i.e. £3.19 million or,
- the value of the benefits calculated at 5 April 2006 (i.e. membership of 35 years)
- using the final pay as at the date of retirement (£278,261) i.e. £2.8 million.

So, the member could take his / her full LGPS rights worth £3.2 million but have to pay tax at the equivalent of 55% on the excess above the primary LTA of £3 million, bringing the net sum down to £3.09 million; or he / she could opt to restrict payment to the Enhanced protection amount of £3.19 million and suffer no excess tax deduction. If the member opts to restrict payment in this way, he / she receives more net (£3.19 million instead of £3.09 million) but the Fund pays out less than the standard LGPS benefits it was funding for (i.e. £3.19 million instead of £3.2 million).

Option B: The Scheme could preclude members who have enhanced protection from accruing further membership in the LGPS beyond 5 April 2006 and treat the benefits accrued to that date as a standard deferred benefit increasing in line with RPI.

This option would mean that members would have to opt for enhanced protection by 5 April 2006 and not 5 April 2009 unless the Scheme is able to permit a refund of pension contributions paid beyond 5 April 2006 in respect of those who opt for enhanced protection between 6 April 2006 and 5 April 2009. We are checking with HMRC whether such a refund would be permissible under the Finance Act 2004.

Option C: The Scheme could preclude members who have enhanced protection from accruing further membership in the LGPS beyond 5 April 2006. However, under this option, the Scheme would still permit benefits accrued to 5 April 2006 to be calculated on the actual final pay figure (subject to the limits above) at the eventual time of retirement.

If this option is chosen, the Scheme must also decide whether to permit insurance cover for death, ill-health and redundancy / efficiency to continue, even though the member is no longer accruing further periods of membership, and how the cost of increasing the benefits in line with final pay and the cost of the ill-health / death / redundancy / efficiency cover is to be met (e.g. should the employee still have to pay a contribution, of less than 6%, to pay for the insurance cover and the fact that the benefits at 5 April 2006 would be increasing in line with salary rather than by RPI).

The ODPM have asked for views on whether the simpler option A is the preferred way to proceed or whether option B, C or other alternatives should be considered.

Clearly, option A provides greater flexibility for the Scheme member and, where a member's normal LGPS benefits would exceed the enhanced protection allowance but the member chooses to restrict LGPS benefits to the Enhanced protection allowance (because the amount of tax saved is more than the extra LGPS benefits above the Primary protection allowance which would be subject to the excess tax charge), the LGPS fund finishes up paying less than the standard LGPS benefits and therefore saves money.

5. Removal of the cap on pensionable pay from 6 April

As was outlined in the ODPM's addendum letter to consultees of 10 December 2005, the capping limits on pay for the purposes of calculating contributions and benefits (£105,600 for 2005/06) for those who joined the Scheme post 31 May 1989 will be removed from the 2006/07 tax year onwards. The favoured approach is to provide for capped active members in the Scheme on 6 April 2006 to have their accrued membership to 5 April 2006 calculated on a pro rata basis between capped and uncapped pensionable pay.

So, if a capped member has 10 years membership and, for example, earns twice the cap (i.e. £211,200), their LGPS benefits pre 6 April 2006 would have been:

Pension of $10 \times \frac{1}{80} \times £105,600 = £13,200$ and
Lump sum of $10 \times \frac{3}{80} \times £105,600 = £39,600$

After the service conversion, their membership would be $10 \text{ years} \times £105,600 / £211,200 = 5 \text{ years}$ which will produce benefits of:

Pension of $5 \times \frac{1}{80} \times £211,200 = £13,200$ and
Lump sum of $5 \times \frac{3}{80} \times £211,200 = £39,600$

Any LGPS benefits aggregated on or after 6 April 2006 that include capped membership will be subject to pro ration.

However, to ensure no detriment, any existing transferred in service that was not subject to the cap would not be pro-rated. Furthermore, the final pay of members who leave within 12 months of 6 April 2006 would all be calculated on uncapped pay (even the part prior to 6 April 2006) to reflect the fact that the service had been adjusted.

Any augmented membership for a capped active scheme member that was granted under regulation 52 prior to 6 April 2006 would need to be pro-rated and the proportion of any whole cost added years purchased under regulation 55 by a capped active scheme member up to 5 April 2006 would also need to be pro-rated.

However, the full period of membership pre the service adjustment would still count in full towards the 3 months needed to qualify for a deferred benefit¹, the 5 years needed to qualify for an enhanced ill health pension, and the 25 year and 85 year rules governing the calculation of the amount of retirement benefits.

Since the ODPM's initial consultation, a number of other issues have emerged which will need further consideration before the final regulations are produced. The ODPM is asking authorities for their views on the following matters:

Consideration 1: It has been suggested that the service adjustment calculation should be based on final pay in the year to 5 April 2006, rather than the rate of pay as at 5 April 2006. This would remove any complexities where fluctuating elements of pay are received in the year prior to 6 April 2006.

Consideration 2: There has been some comment that members should be given the facility to pay for what is perceived as a loss of years (even though the value of benefits at the point of the service adjustment will not have decreased and, in fact, the future value of the pre 6 April 2006 membership will increase quicker than under the Earnings Cap regime if salary rises post 5 April 2006 outstrip the rise in the Retail Prices Index, being the index by which the Earnings Cap was increased each year). The service adjustment proposal may be the simplest method to ensure there is no "windfall" for members subject to the Earnings Cap when the cap is removed. However, the flexibility exists within the present Scheme rules for employers to deal with any perceived detriment that the service adjustment method might produce e.g. employers can:

- augment membership under regulation 52, or
- contribute to a Shared Cost AVC

subject to these being within the limits set by the new tax regime and as long as this can be shown as reasonable within the employer's relevant policy on the use of augmentation or SCAVCs.

In considering this matter, employers would need to have regard to:

- the individual circumstances of each case (e.g. does the employee's salary already include an increase to compensate for the present Earnings Cap, or has the employer already contributed to a Shared Cost AVC to compensate)
- the increased liability which could fall to a fund or employer.

The ODPM has asked authorities for their views.

There will be issues for the public sector transfer Club if different schemes participating in the Club adopt different approaches in relation to the retention or

¹ 2 years in Scotland

removal of the Earnings Cap. We are awaiting details of how the Club rules will cater for this.

6. Normal retirement age of Councillors

The normal retirement age for Councillor members is currently 70. In order to allow the same provisions for flexible retirement that are permissible under the Finance Act 2004 (drawing a pension from an employer while still employed by that employer) to apply to Councillors, and to deal with age discrimination issues relating to the setting of a pivotal scheme retirement age, the Scheme could change the normal retirement age for Councillors to 65 as from 6 April 2006. It would be possible to join the scheme between 65 and 75, and a decision would be needed as to whether this membership would be subject to the actuarial increase applying to benefits accrued before age 65 when that pension is taken after 65.

The LGPC position on this has been, ever since councillors pensions were introduced in 2003, that the normal retirement age in the Scheme for councillors should be 65.

7. Extinguishing of pension rights relating to refunds

For the purposes of the Finance Act 2004, the LGPS is treated as one single scheme within which it will be possible for scheme members to hold more than one "arrangement" (e.g. separate pension rights connected to multiple employments within one pension fund or separate employments in Sussex CC and in LB Lewisham or pension rights connected to one employment and an AVC arrangement).

It will no longer be possible, under the terms of the Finance Act 2004, to pay refunds to Scheme members relating to one arrangement where they have another arrangement in the Scheme, due to the fact that the LGPS is considered to be one single Scheme and the Finance Act requires all rights under a pension scheme to be extinguished on the payment of refund. Furthermore, refunds will not be permitted where the member has previously had a 'benefit crystallisation event' (i.e. a pension coming into payment). Therefore, the ODPM is suggesting that the Scheme could adopt an approach whereby it will not be possible to pay a refund to a scheme member who has more than one arrangement in the Scheme (relating to active, deferred, pensioner or pension credits) unless all arrangements have ceased and the member has less than 3 months total membership. It will also not be possible to pay refunds to individuals who have previously had overseas transfers out. Although not required for the purposes of the Finance Act 2004, the LGPS in England and Wales and the LGPS in Scotland could be considered to be one scheme only. The ODPM are asking authorities whether or not they agree. However, it is difficult to see that the LGPS in England and Wales and the LGPS in Scotland can be considered as one Scheme for the purposes of the Finance Act 2004.

8. Trivial commutation

The overriding provisions in the Finance Act 2004 relating to trivial commutation will also require some amendments to be made to the LGPS. Generally speaking, the overriding provisions require:

- that trivial commutation can only be permitted if the overall value of a individual's pension rights (in all his or her arrangements) is no greater than 1% of the standard lifetime allowance (1% = £15,000 in 2006/07),
- the payment of all trivial commutation lump sums may only be made within a 12 month period, sometime between age 60 and age 75,
- the payment of a trivial commutation lump sum in a pension scheme extinguishes all rights to benefits in that pension scheme.

The overriding provisions provide that trivial commutation may apply in relation to active and deferred members, as well as pensioners.

As a result of these provisions, the Scheme could adopt an approach whereby trivial commutation payments can continue to be paid from the LGPS, subject to the overriding Finance Act 2004 provisions, but only in respect of pensioners, deferred members and pension credit members (i.e. any active member would need to opt out and become a deferred member). The provisions would be strengthened to ensure, however, that a payment was not permitted unless all LGPS benefits were being commuted, including those in a Scottish LGPS Fund. The ODPM are asking whether authorities agree.

9. Scope for buying added years

As the ODPM proposed in their consultation document, the current 15% contribution limit should be removed and they also suggested that regulation 55 should be amended to limit the number of added years that may be purchased to a maximum of six and two-thirds years. To prevent additional liabilities being placed on the Scheme, particularly if members are permitted to contribute up to 100% of salary into the Scheme, the Scheme could adopt one or more of the following additional approaches:

Option A: Scheme members would only be permitted to purchase one year for every year they have left before retirement, which falls within the six and two-thirds limit. Therefore a Scheme member aged 60, who is planning on retiring aged 65 would only be able to buy 5 added years.

Option B: In the event of early departure, ill health or death, Scheme members would only receive pro rata what they had paid for. Protection would remain in force for those in existing added years contracts at 5 April 2006.

Option C: The facility to buy-out the remaining balance of an added years contract with cash following early retirement on redundancy or efficiency grounds would be removed but this right would remain in force for those with existing added years contract at 5 April 2006.

The ODPM are asking whether authorities support any or each of these options and, if so, on what basis or do authorities have other suggestions.

10. Debit on divorce

Where a Scheme member gets divorced and part of their pension is allocated to their former partner, the member's pension is reduced. This is known as a pension debit.

Currently the Scheme member is not permitted to make good this reduction in benefit.

The ODPM are asking authorities to consider whether the regulations should be amended so active members who are pension debit members can rebuild any lost benefit entitlement.

11. Pension Credit

It is also proposed that pension credit members who have an entitlement to a pension credit lump sum retirement grant should be entitled to increase the value of it by giving up some pension, based on a commutation factor of 12:1

The ODPM are asking authorities for their view on this proposal and whether or not those pension credit members without entitlement to a lump sum (i.e. those whose credit was derived from a scheme member's pension that was already in payment) should also be entitled to commute part of their pension for a lump sum.

12. Limits on employee contributions for scheme members with more than one "arrangement"

In their original consultation, the ODPM suggested that the contribution limit of 15% of taxable pay be removed. The Finance Act specifies that scheme members will be eligible for tax relief on pension contributions of the higher of £3,600 or 100% of their UK taxable earnings in the tax year.

The ODPM is now considering the proposal to include a limit whereby LGPS contributions in **each separate** LGPS arrangement are limited to 100% of taxable pay in relation to **that** LGPS arrangement. Individuals would not be able to pay additional contributions into the LGPS relating to taxable earnings elsewhere. The ODPM believe this would still allow plenty of flexibility but keep administration relatively straight forward.

The LGPC line on this is that, from the Fund's point of view, it might be safer to retain a limit on contributions per arrangement in the Scheme i.e. one that is higher than the current 15% limit but lower than 100%; say 25%.

It should be noted that members would be able to take out alternative arrangements to maximise tax relief in relation to other employments.

13. Annual Allowance

For the purposes of calculating the growth in benefits relating to the LGPS (including AVCs) for comparison with the Annual Allowance, the ODPM is proposing to include a provision within the LGPS specifying that the period end date should cease on 31 March each year in respect of all current and future members (including members who continue paying AVCs in the future). The ODPM is asking authorities for their view on this.

If a period end date is not incorporated into the regulations, this will result in:

- periods running to 5 April for current members;
- periods running to anniversaries of date of joining for future members;
- periods running to anniversaries of commencing AVC payments for future members paying AVCs.

Employers who currently use the augmentation provision under regulation 52 to award extra membership in a year other than the final year of employment will need to consider whether augmentation awarded after 5 April 2006 will result in the Scheme member's Annual Allowance being exceeded.

14. Exceptional ill-health commutation

It is understood that the DWP will be making regulations to permit the commutation of GMP and Section 9(2B) rights in cases of exceptional ill-health commutation. The tax treatment of exceptional ill-health commutation payments is also treated differently under the Finance Act 2004 as the payment will be counted towards the lifetime allowance. Such a payment can only be made if certification is made by a Registered Medical Practitioner. The ODPM propose to amend the LGPS to incorporate these changes and to permit the payment of a lifetime allowance excess lump sum (taxable at 55%) if an individual exceeds their lifetime allowance by payment of the exceptional ill-health commutation. The ODPM are asking whether authorities agree.

15. Refund of excess contributions lump sum

The Finance Act 2004 permits a refund to be paid where an individual has paid more contributions than they are entitled to receive tax relief on (i.e. more than 100% of their UK taxable pay). The ODPM propose to incorporate a provision to allow such refund payments to be made by administering authorities from the Fund and are asking whether authorities agree.

16. Flexible retirement

The draft regulations propose that if, with their employer's permission, a member aged 60 or over reduces their contractual hours or moves to a lower graded post they will be able to draw all their accrued LGPS pension benefits whilst continuing to draw salary and build up additional pension rights. The LGPS Secretariat believes

that there is no good reason that this facility should not apply from age 50, rather than age 60 provided the employer pays the full capital cost of early release of benefits where flexible retirement occurs prior to age 60. However, it is important that employers start considering the implications of flexible retirement from an HR perspective now so that they are in a position to have a clear view of what their policy on this matter might be when the LGPS Regulations are amended to permit flexible retirement. The administering authority might need to consider its abatement policy, although it may be that the actual amendment regulations will disapply abatement in the case of flexible retirement.

17. Age of admission to the Scheme

If the age at which employees may join or remain in the Scheme is increased from 65 to, say, the day before the 75th birthday it may be that those employees already aged 65 and over who are not in the Scheme will have to be automatically brought into the Scheme on 6 April 2006. Employers may, therefore, wish to identify these cases in advance so that, should the amendment regulations require automatic enrolment (with the right to opt out), the employees concerned can be forewarned and the appropriate payroll arrangements made. Any payroll error / exception / warning reports linked to an employee attaining age 65 (e.g. warning that an employee has to come out of the Scheme or is not eligible to join the Scheme) would also need to be amended. Similarly, those employers who permit eligible councillors to join the Scheme may also wish to identify those aged 70 or over in order to offer them the option of joining the Scheme from 6 April 2006 should the age 70 limit for councillors be raised to, say, age 75.

18. Information for Scheme members on Annual and Lifetime Allowances

There is no responsibility on the administering authority to inform Scheme members of the increase in the value of their benefits during the Scheme year for the purposes of the Annual Allowance test. However, administering authorities might wish to provide a service to Scheme members who have a responsibility to disclose on their Self Assessment Tax Return if they have exceeded the Annual Allowance. One option might be for the increase in the value benefits for all members to be shown on their Annual Benefit Statement. However, this would mean that all statements would have to be issued in time for the employee to complete their tax return in September. Also, if pension records are not 100% accurate this could result in incorrect amounts being shown on the statement. An alternative would be to only provide information to those where the value of their LGPS benefits (including AVCs) has exceeded the Annual Allowance and to any other member who requests the information (as they may have other pension rights elsewhere which, in aggregate with the increase in the value of their LGPS benefits, might have exceeded the Annual Allowance). For the small number of cases involved, an individual calculation could be produced and checked for accuracy.

Until a Benefit Crystallisation Event occurs in the LGPS there is no requirement to show the value of a member's benefits as a percentage of the Lifetime Allowance. However, again as a service to members, administering authorities might wish to

consider showing on an active member's Annual Benefit Statement the percentage of the allowance the member's current benefits are worth and what their percentage value will be assuming service to age 65 (and no pay rises) so that the member can better decide whether or not it is worth, for example, paying AVC's. However, this type of information might be better provided at the point when a scheme member first expresses an interest in AVCs or in purchasing whole cost added years.

When a Benefit Crystallisation Event occurs, the Scheme member should be informed of the percentage of the Lifetime Allowance (or Primary or Enhanced Lifetime Allowance, as appropriate) that the benefits represent. Furthermore, it is a requirement that pensioners must annually be reminded of this percentage. This may be achieved by putting it on their end of year P60. This would, of course, entail reprogramming the payroll system to hold in the pensioner's payroll record the percentage figure provided by the Pension Section and reprogramming the P60 production programme to ensure it outputs the figure on the P60. Alternatively, the percentage could be held on the computerised pensions administration system with a letter being produced by the system and issued annually.

19. Existing AVC policies

As it looks likely that the LGPS regulations will permit at least 25%, if not 100%, of an AVC pot to be taken in the form of a tax free lump sum, it would be prudent for administering authorities to check with their AVC provider that their AVC policies do not contain a restriction which provides for the AVC to be taken in pension form only. If so, the policies may need to be rewritten / amended.

At the present time, the administering authority has a legal duty to offer an AVC and to ensure that AVC investment returns are reasonable. This derives from section 111 of the Pension Schemes Act 1993 which says:

111 Voluntary contributions

(1) Except in such cases as may be prescribed, and except so far as is necessary to ensure that an occupational pension scheme or a personal pension scheme has, or may be expected to qualify for, tax-exemption or tax-approval, the rules of the scheme -

- (a) must not prohibit, or allow any person to prohibit, the payment by a member of voluntary contributions;
- (b) must not impose, or allow any person to impose, any upper or lower limit on the payment by a member of voluntary contributions;
- (c) must secure that any voluntary contributions paid by a member are to be used by the trustees or managers of the scheme to provide additional benefits for or in respect of him; and
- (d) must secure that the value of the additional benefits is reasonable, having regard -
 - (i) to the amount of the voluntary contributions; and
 - (ii) to the value of the other benefits under the scheme.

However, from 6 April 2006 the legal requirement to offer an AVC is removed (see section 267 of the Pensions Act 2004 which deletes section 111 of the Pension Schemes Act 1993). Nevertheless, as the LGPS will continue to offer an AVC facility thereafter as an integral part of the Scheme, administering authorities should continue to exercise due diligence in monitoring their AVC provider's investment returns and change providers if and when appropriate. Individuals are, of course, free to make their own decisions as to the merit, or otherwise, of paying AVCs to the Fund's AVC provider and the employer / administering authority is not recommending the AVC scheme to the member nor providing financial advice, any more than they are recommending the main LGPS. From 6 April 2006 employees will be free to pay up to 100% of UK taxable income (or £3,600 if greater) into any number of pension arrangements of their choice.

20. Recalculation of benefits

There are worrying indications from HMRC that where a recalculation of benefits is made more than 3 months after the first calculation, no further tax free lump sum may be made (as this would constitute an unauthorised payment). The additional benefits could only be taken as pension or, if part were taken as a lump sum, it would be subject to a tax charge on the individual and a potential charge on the scheme administrator. This would potentially impact on a large number of cases e.g. recalculations of benefits resulting from:

- retrospective pay awards
- appeal determinations
- late notification of membership changes (e.g. changes in hours)
- retrospective regradings
- late notification of change in final pay calculation
- performance related pay paid after the year end (e.g. person leaves in December but payment is not made until the following June following the year end assessment)
- late GAD guidance

and, perhaps more worryingly, on the subsequent balancing PI payment on

- deferred benefit lump sums (e.g. a deferred benefit brought into payment in October 2005 has only had PI applied under the April 2005 PI Order; a further PI payment on the deferred lump sum is due when the April 2006 Order is issued)
- pensioner death grants
- deferred benefit death grants
- lump sums where there had been a certificate of protection of pay
- lump sums where one of the previous 2 years pay had been used

In all of the latter cases the PI Orders issued under the PI Act 1971 require administering authorities to pay a balancing payment. Will PI be deemed to be a further benefit payment by HMRC? If so, how will the PI Act and the Finance Act interact? On the face of it, administering authorities do not have the option to pay the

balancing PI payment as anything other than a lump sum in accordance with the PI Act and so would be making an unauthorised payment with all the subsequent tax and reporting problems (even though required to make the payment by the PI Act). We are trying to get HMRC to change their position on this matter and will let administering authorities know the outcome.

21. Information to Scheme members

There are a number of matters that administering authorities may wish to bring to the attention of Scheme members i.e.

- there are major changes to the LGPS occurring as a result of changes to the tax regime governing pension schemes (as well as changes to the Scheme regarding the removal of the 85 year rule)
- scheme members are responsible for deciding whether to apply for Primary or Enhanced Lifetime Allowance protection [NB. The LGPC intends to draw up a guide for members on this matter as soon as it is clear how the LGPS Regulations will deal with Enhanced protection and with any excess over and above the standard LTA or Primary protection]
- scheme members are responsible for informing HMRC if the increase in the value of all their pension benefits is greater than the Annual Allowance (£215,000 in 2006/07)
- scheme members might wish to defer retirement until at least to 6 April 2006 if they wish to draw a bigger tax free lump sum and, potentially, take 100% of any AVC pot as a tax free lump sum. Alternatively, members with an AVC pot who retire before 6 April 2006 might wish to defer making a decision in relation to their AVC pot until 6 April 2006 if they wish to be able to take up to 25% of their AVC pot as a tax free lump sum
- scheme members might wish to defer retirement until at least 6 April 2006 if they want to count more than 40 years membership at 60 (or for pre 1 June 1989 members, more than 40 years at 60, 41 at 61, etc)
- scheme members might wish to defer retirement to 6 April 2006 if they have a small pension and want to commute it. Currently, pensions of less than £195 per annum can be commuted for a one off lump sum payment if the member has reached state pension age. From 6 April 2006 the new limit is £15,000 but:
 - the trivial commutation can only be permitted if the overall value of a individual's pension rights (in all his or her arrangements) is no greater than 1% of the standard lifetime allowance (1% = £15,000 in 2006/07),
 - the payment of all trivial commutation lump sums may only be made within a 12 month period, sometime between age 60 and age 75,
 - the payment of a trivial commutation lump sum in a pension scheme extinguishes all rights to benefits in that pension scheme.

However, a member over state pension age might wish to leave before 6 April 2006 if they wish to commute an LGPS of less than £195 per annum but have other funds where the capital value in total exceeds £15,000 or which won't come into payment within 12 months

- members who wish to opt for Enhanced LTA protection should, before 6 April 2006, stop paying AVCs (but not life assurance AVCs) and any other contributions to money purchase pension schemes (e.g. where they earn less than £30,000 and are currently paying into a concurrent Stakeholder or personal pension plan)
- scheme members should let their employer and the pension section know if they intend to retire on or shortly after 6 April 2006 so that the member can be sent a declaration form regarding any other benefits they may have in payment and whether they have a Primary or Enhanced LTA protection certificate. This information is needed to enable administering authorities to determine whether overall benefits exceed the LTA (thereby necessitating a tax charge on the excess) and to allow benefits to be processed on time. Technically, if the member does not provide the required declaration form, the administering authority would have to assume that the member had exceeded the LTA and tax the LGPS benefits accordingly
- active members with a pension debit should be informed that as from 6 April 2006 they will be allowed to increase their pension benefits to make up for the debit applied to their benefits
- members wishing to surrender part of their pension in favour of a spouse, civil partner or dependant will need to retire before 5 May 2006 and have made an election to surrender by 5 April 2006
- scheme members should be notified that the pension input period for the Annual Allowance will be nominated in the LGPS Regulations as running to 31 March each year for main scheme benefits and in-house AVCs, both those currently in existence and those commencing at a later date. This is to ensure that administering authorities don't have scheme members nominating alternative dates - the first nomination is the one that must be adhered to and we should seek to avoid a situation where the member nominates a different date because they weren't aware the Regulations are going to specify 31 March
- inform members currently subject to the Earnings Cap that, if the LGPS removes it, they will have a service adjustment and start paying contributions on their uncapped salary from 6 April 2006. Ensure that the payroll system is able to comply and ensure any payroll error reports / warnings / restrictions are amended.

One other point to consider relates to any existing Earmarking Orders. As you will know, the Courts are now expressly required to take account of pensions on divorce, nullity of marriage, judicial separation or dissolution of a civil partnership and have the power to make the following "earmarking orders":

- an Order requiring the Scheme to pay a specified percentage or all of a member's pension when that pension comes into payment to the member's "ex-spouse" or "ex-civil partner", if and when the pension becomes payable i.e. the deduction to be paid to the "ex-spouse" or "ex-civil partner" is taken from the member's net pension after tax. (Note: this power does not apply in Scotland);
- an Order requiring the member to exchange pension for lump sum if and when the Scheme gives the member that option (Note: this power does not apply in Scotland);
- an Order requiring the Scheme to pay part or all of the member's lump sum to the member's "ex-spouse" or "ex-civil partner" if and when the lump sum becomes payable;
- an Order requiring the Scheme to pay part or all of a lump sum death grant to a member's "ex-spouse" or "ex-civil partner" if and when the member dies i.e. under section 25C(2)(a) of the Matrimonial Causes Act 1973 or section 12A(3)(a) of the Family Law (Scotland) Act 1985.

Clearly, any existing Earmarking Order requiring a specified percentage of an existing active or deferred member's pension to be paid to the "ex-spouse" or "ex-civil partner" when the pension is brought into payment will probably have been made by the Court based on the current standard LGPS pension and lump sum rules. If, under the new LGPS rules, the member decides to commute pension into lump sum, the "ex-spouse" or "ex-civil partner" will get a percentage of a smaller residual pension. Where an event occurs which is likely to result in a significant reduction in the benefits payable under the LGPS the administering authority must inform the "ex-spouse" or "ex-civil partner" of the event and the likely extent of the reduction in benefits within 14 days of the event occurring. This is a requirement of regulation 5 of the Divorce etc (Pensions) Regulations 2000 [SI 2000/1123].

Conversely, where under any existing Earmarking Order, the Scheme is required to pay a percentage of the member's retirement lump sum to the member's "ex-spouse" or "ex-civil partner" if and when the lump sum becomes payable and the member either opts to commute some pension into lump sum, or is required by the Order to commute the maximum pension into lump sum, the cash that will be received by the "ex-spouse" or "ex-civil partner" will be greater than perhaps had been anticipated by the Court prior to the LGPS Regulations being amended. Administering authorities should consider alerting any Scheme member who currently has an earmarking order against the lump sum retirement grant which is expressed as a percentage of the lump sum so that the member, if he / she wishes or intends to take a larger lump sum under the new LGPS rules, can seek a variation to the Order under section 31 of the Matrimonial Causes Act 1973.

22. Registering the scheme administrator / sub- scheme administrator and practitioners

Administering authorities will have received an e-mail from HMRC at the tail end of last year offering the opportunity for pre registration of Scheme Administrators and pre authorisation of Practitioners, in preparation for the introduction of the on line Pension Scheme Service from April 2006. HMRC are not automatically transferring existing details they hold on administering authorities across to their new system as they wish to be sure that details are correct. Within the new pensions tax regime, each registered pension scheme will be expected to provide details of a scheme administrator who will have responsibility for tax charges, interest and penalties under the new regime. The administrator would also provide details of Practitioners who the administrator authorises to deal with certain matters on the administrator's behalf e.g. the filing of reports with HMRC. The e-mail from HMRC included documents that gave information and guidance on the exercise, including:

- General guidance
- A template to be completed for pre registration of Scheme Administrators and authorisation of Practitioners
- Template completion notes
- A note on the role of the Scheme Administrator
- A glossary of terms.

Since then, HMRC have issued the draft Registered Pensions (Splitting of Schemes) Regulations 2006. These permit large, decentralised schemes, such as the LGPS, to be treated as a single scheme, but with each Fund being treated as a sub-scheme. The Secretary of State could be named in Schedule 1 of the draft SI as the scheme administrator, responsible for such high level functions as contracting-out, and each administering authority would then be named as a sub-scheme administrator in Schedule 2 of the draft SI. The ODPM has written to HMRC seeking clarification of certain matters in relation to the draft SI. However, it seems likely that the LGPS will follow the administrator / sub-administrator route permitted by the draft SI. The ODPM (and SPPA in Scotland) have to make a decision on this by 17 February 2006. If the LGPS does go down this route the ODPM / SPPA will either shortly be asking you for the following information, or asking you to send it direct to HMRC:

- Name of the administering authority
- Your Fund's approved scheme SF reference number
- Contact Address for your Fund's designated sub-scheme administrator
- Contact e-mail for your Fund's designated sub-scheme administrator
- Contact telephone number for your Fund's designated sub-scheme administrator

Further information is available in the Pension Scheme newsletters, particular No.8. These can be viewed at www.hmrc.gov.uk/pensionschemes/pts-newsletters.htm

23. Guide to tax simplification

The LGPC has commissioned Karen McWilliam of Hymans Robertson to produce a guide to the (so-called) tax simplification. A draft of the Guide is available at <http://www.lg-employers.gov.uk/pensions/guides/index.html> together with a list of outstanding issues. The current draft is a bit of a chameleon, changing every now and again as we get clarification of points from HMRC and think of new issues. Please, therefore, bear with us. We hope to have the final version available before 6 April 2006 but thought you might wish to view the draft as it is progressing. If there are issues that you feel are not addressed or adequately covered in the draft guide please e-mail terry.edwards@lg-employers.gov.uk with a copy e-mail to karen.mcwilliam@hymans.co.uk and brian.town@odpm.gsi.gov.uk

24. LGPC training events

The LGPC is planning to run 12 regional training events on the April 2006 changes to the LGPS (including the tax changes). Details are contained in LGPC Circular 179 at <http://www.lg-employers.gov.uk/documents/pensions/circulars/179dec05.doc>

Early booking is recommended as places are limited. Bookings are made via the events booking facility on the Employers' Organisation website at www.lg-employers.gov.uk/events. When booking, you will need full delegate details to hand including the address to which the invoice for payment is to be sent. In the event that the workshop at your preferred location is full, you are advised to enter your name on the reserves' list as this will ensure you are given priority on any overflow places or events that arise.

If you experience any difficulties in using the website booking facility or do not have access to the internet, please contact Elaine English, LGPC Executive Officer, on 020 7296 6745.

25. Pension Officer Group meetings

Pension Officer Groups might wish to consider arranging a special POG meeting late in March by which time it is hoped the Amendment Regulations will have been made and laid. This will give Pension Managers the opportunity to discuss the Amendment Regulations and their implications. If you wish a representative from the LGPC to attend please e-mail terry.edwards@lg-employers.gov.uk to check on the availability of LGPC staff since, as you will appreciate, the calls on the LGPC Secretariat at that time are likely to be great.

26. Disclaimer

The above is purely my personal understanding of the present situation. I have tried to provide comment on as many issues as I can think of at this time but will, inevitably and undoubtedly, have missed some.

Yours sincerely



Terry Edwards

Assistant Director (Pensions)